Estate Planning Insights

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A BRIEF TRANSFER TAX UPDATE & A RECURRING ESTATE PLANNING PROBLEM

Relevant Transfer Tax Amounts. We will start with the relevant "transfer tax" exemption amounts for 2019. The estate tax exclusion amount, lifetime gift tax exclusion amount and GST exemption amount for 2019 is $11,400,000. This is the $10 million basic exclusion amount established by the Tax Cuts and Jobs Act passed in December 2017, with inflation adjustments starting from a base year of 2011. As noted in prior newsletters, the $10 million basic exclusion amount is scheduled to drop back down to $5 million on January 1, 2026. Of course, Congress could change the basic exclusion amount any time before that.

The annual gift tax exclusion amount remains at $15,000 per *donor* (gift-giver) per *donee* (gift recipient). The transfer tax rate (i.e., estate, gift and GST tax rate) remains at 40%.

Clawback. As noted, the basic exclusion amount is currently $10 million but will drop to $5 million on January 1, 2026 (ignore inflation adjustments in this section). Assume a donor makes *taxable gifts* totaling $10 million before 2026 and then dies after 2025 (when the exemption amount is only $5 million). Will that person's estate owe estate taxes on the difference? Per a regulation released in November 2018, the answer is "No." We will not go into more detail in this newsletter. Clients who wish to pursue making taxable gifts before 2026 of most or all of their lifetime gift tax exclusion amount should contact us.

Bypass Trust Or Not? Too many married couples are failing to review their old Wills and revocable trust documents and are dying with Wills and trust documents that require a Bypass Trust to be set up and funded when the first spouse dies. (To save space, we will refer to both a Will and a revocable trust as a "Will" in this section.) The Executor cannot simply ignore what the Will says. If the Will says a Bypass Trust is supposed to be set up and funded when the first spouse dies, the Executor must comply with that directive to avoid breaching his fiduciary duty. Sometimes, if everyone in the family and the Executor sign a legal document in which they all agree that the Bypass Trust should not be set up and funded, the Executor can avoid establishing the Bypass Trust. However, the cost of that sort of post-death agreement is much greater than the cost of obtaining a new Will. (An ounce of prevention is worth a pound of cure.)

A prudent and responsible person will review her estate planning documents on a regular basis. This is necessary due to how often Congress and the Texas Legislature change the laws. The estate tax laws, in particular, have changed drastically over the past eighteen years.

Prior to 2013, nearly all married couples with a total net worth exceeding $1 million had Wills that created a Bypass Trust on the death of the first spouse. Why? **Because Married Couples Do Not Automatically Get Two Exemptions From The Estate Tax!** Married couples must "do something" to take advantage of the estate tax exemption amount available to each spouse.

Prior to passage of the American Taxpayer Relief Act of 2012 ("ATRA") in January 2013, the estate tax exemption amount was at risk of declining to just $1 million (due to the expiration of temporary tax laws). Thus, because married couples do not automatically get two exemptions from the federal estate tax, couples with more than $1 million created a Bypass Trust in their Wills, to receive and hold the exemption amount belonging to the first spouse to die, so that the Bypass Trust assets would "bypass" estate taxes on the death of the surviving spouse. In that way, if the exemption amount was $1 million, a couple could transfer a total of $2 million without incurring estate taxes.

ATRA made two important changes to the federal estate tax laws: (i) it made $5,000,000 the "permanent" and "unified" transfer tax exemption amount and provided that such exemption amount would be indexed for inflation (starting from the year 2011) and (ii) it made the "portability election" permanent (portability first became an option in 2011 under a prior, temporary law that expired). As noted first above, however, the Tax Cuts and Jobs Act has doubled the $5 million estate tax exemption amount to $10 million through the end of 2025.

We have discussed portability many times in our newsletters. It is another way for married couples to obtain two exemptions from the estate tax without having to establish a Bypass Trust.

There are both advantages and disadvantages of a Bypass Trust. By the same token, there are both advantages and disadvantages of "simple Wills" that do *not* create a Bypass Trust. We have discussed those matters, in detail, in many prior newsletters.

Bottom Line: Married couples with Wills that were signed before 2013 who have not come in for an estate planning check up after 2012 need to come in for a check up this year. Single people who have not had an estate planning check up for more than 5 years need to come in, too.

A "Recurring Estate Planning Problem." We are in the midst of a "nonprobate revolution." Over the past 30+ years, people have been using more and more "nonprobate arrangements" to transfer their assets at death. In my view, there are three categories of nonprobate arrangements (arrangements that cause assets to be transferred outside your Will at death):

1. Beneficiary Designation Assets.
2. Trust Assets.
3. Multi-Party Nonprobate Assets.

Beneficiary designation assets are those assets for which the *only* transfer document is the beneficiary designation (also referred to as the "beneficiary designation form"). This could be a paper or electronic beneficiary designation submitted by the titled owner of the beneficiary designation asset to the company sponsoring the asset or a "default" beneficiary designation that applies if there is no valid or effective beneficiary designation on file. The four types of beneficiary designation assets are (i) life insurance, (ii) employee benefit plans (such as 401(k) plans and profit-sharing plans), (iii) IRAs (of all types) and (iv) annuities. A beneficiary designation may name a trust as the beneficiary, but it is still the beneficiary designation that transfers the beneficiary designation asset to the trust. Again, the beneficiary designation is the only transfer document for assets in this category. Thus, a beneficiary designation should always be submitted for each beneficiary designation asset.

Trust assets refers primarily to assets held in (titled in the name of) a revocable trust at the time of the trust "settlor's" (i.e., trust creator's) death. We are referring to a revocable trust (also called a "living trust") that has dispositive provisions and not a revocable management trust that "pours back" to the settlor's probate estate when he dies. Not all assets can be titled in the name of a living trust while the settlor is living. Thus, certain assets, such as IRAs, remain titled in the settlor's individual name and are transferred at death pursuant to the beneficiary designation. Many of our clients use living trusts. A living trust may be the "best defense" against inappropriate multi-party nonprobate arrangements. But it is more complex (and expensive) than a Will and not everyone needs to use it.

Multi-party nonprobate assets refers to accounts and other assets that utilize a form of title or registration that causes the account or asset to be transferred on the owner's death outside his Will. Examples in this category include (i) joint accounts that include a "right of survivorship" (such as Joint Tenants with Right of Survivorship [JTWROS, JT TEN], community property with right of survivorship, and multi-party accounts with a right of survivorship), (ii) single or joint accounts that include one or more "Pay on Death" "("POD") beneficiaries, (iii) single or joint accounts or other assets that include one or more "Transfer on Death" ("TOD") beneficiaries, and (iv) the so-called "Totten trust" account (an account not related to an actual trust in which the depositor is named as "Trustee" for one or more beneficiaries). These arrangements are not required and are the ones that cause the most problems. *Normally, they should be avoided by people who want their estate plan in their Will to be effective.*

As we have discussed many times before, assets and accounts that come within these nonprobate arrangements will pass outside your Will upon your death. In other words, these assets and accounts will *not* be part of your estate plan in your Will and will *not* be available to the executor of your estate to pay your debts, final income taxes, post-death expenses and specific gifts made in your Will.

In our newsletter dated April 30, 2018, we discussed, in particular, the use of Transfer on Death (TOD) arrangements. We included examples of four actual cases where the use of TOD on the decedent's account(s) caused serious problems. Although we feel that those examples clearly explained the problems caused by the use of TOD arrangements, we keep having this issue arise with more and more clients every week. Thus, we are going to use some numbers in our example this time (and we will not simply be focusing on TOD arrangements but on *all* nonprobate transfers).

<u>An Example Of The Problem, With Numbers</u>. Mary and Joseph have three children and six grandchildren. They have always lived in Texas. They have a combined net worth of $4 million. All of their assets are community property.

Mary and Joseph own a home worth $800,000. In their Wills, they are leaving the community property one-half interest in their home owned by the first spouse to die to the surviving spouse as a specific gift.

Mary and Joseph each own sizeable IRAs that were created when they retired and rolled over their respective 401(k) plans to IRA rollovers. Their IRAs are community property under Texas law. Despite IRS Publication 555, IRAs accumulated by married persons living in Texas are NOT the separate property of the named IRA owner. There is no federal court case that has made such a ruling. In addition, the IRS has misconstrued Section 408(g) of the Internal Revenue Code. (*See* page 4 of this newsletter which notes an article that addresses these matters.)

Mary's IRA rollover is worth $700,000 and Joseph's IRA rollover is worth $1,200,000. Pursuant to a beneficiary designation on file with the custodians of their respective IRAs, Mary and Joseph have named each other as the primary beneficiary of their respective IRAs. (They have each named their three children as the contingent beneficiaries of their IRAs and included "per stirpes.") In addition, in their Wills, Mary and Joseph have each made a specific gift to their spouse of their community property one-half interest in the IRA titled in their spouse's name (so that the surviving spouse will become the 100% owner of the IRA titled in his/her name upon the first spouse's death).

Mary and Joseph also have a joint after-tax brokerage account worth $1,000,000. The brokerage account is titled in both of their names as Joint Tenants with Right of Survivorship (JT TEN).

Finally, Mary and Joseph have a joint checking account and a joint savings account with XYZ Bank worth a total of $300,000. Each account with XYZ Bank is titled in both of their names as a Multi-Party Account with Right of Survivorship. That is the only form of title "allowed by" XYZ Bank for joint accounts.

Initially, Mary and Joseph wanted to leave each of their 6 grandchildren cash gifts on *each* spouse's death in the amount of $20,000. They have a special relationship with each of their grandchildren and they really wanted to make these gifts. To their way of thinking, this is a relatively small amount out of their total net worth.

I told Mary and Joseph that no provision could be included in their Wills making cash gifts to their grandchildren on the first spouse's death because the Executor will not have $120,000 in cash or other probate assets to make those gifts when the first spouse dies. I verified that they did not intend for their home to be sold when the first spouse dies simply to obtain cash to make the cash gifts to their grandchildren. Also note that, because of community property law, there would have to be $240,000 in probate assets on the first spouse's death not passing to the surviving spouse to enable the Executor to distribute $20,000 to each grandchild ($120,000 total) out of the first spouse's estate on his/her death.

Review the assets owned by Mary and Joseph. On the first spouse's death, the IRA titled in the deceased spouse's name, the joint brokerage account, and the two bank accounts will pass directly to the surviving spouse outside the deceased spouse's Will (as a nonprobate transfer). And while the deceased spouse's community property one-half interest in the home and the IRA titled in the surviving spouse's name are *probate* assets, those assets are also going directly to the surviving spouse due to specific gifts in the Will. Thus, again, there are no "probate assets" available to make the $20,000 cash gifts to the 6 grandchildren on the death of the first spouse. Further, if the surviving spouse decides to make those gifts using funds in the bank or brokerage accounts, he or she will be making a "taxable gift" to each grandchild because the gift tax annual exclusion amount is just $15,000 per donor per donee. Thus, the $20,000 cash gifts to the grandchildren on the *first* spouse's death had to be "scrapped."

What about giving each grandchild $20,000 on the death of the surviving spouse? That should be possible, even if Mary and Joseph arrange their bank and brokerage accounts to pass outside the Will of the surviving spouse as nonprobate transfers, *as long as the surviving spouse still owns their home when he/she dies*. The home can be sold by the Executor on the death of the surviving spouse and the $120,000 needed for the cash gifts to the grandchildren can be paid using some of the proceeds from the sale of the home.

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But what if the home is sold before the death of the surviving spouse? Can the grandchildren's cash gifts be made when the surviving spouse dies? It depends. If the proceeds from the sale of the home go into the brokerage or bank accounts owned by the surviving spouse but the surviving spouse has named the three children as the TOD or POD beneficiaries of those accounts (as well as the beneficiaries of the IRAs), again, there will be no probate assets available to make the cash gifts to the grandchildren when the surviving spouse dies. So, as noted in this example, it may not always be possible to make specific gifts, such as $120,000 to 6 grandchildren out of a $4 million estate, in cases where most or all of the accounts and assets have been structured to pass outside the Will pursuant to a nonprobate arrangement. It is true that nonprobate transfers "avoid probate." But it is also true that the estate plan in the Will may be decimated by the use of nonprobate arrangements.

There are two solutions. If you are going to use a Will as your estate planning vehicle and you want the provisions in your Will to be effective on your death, you cannot structure all of your accounts to pass outside your Will when you die. The other solution is to use a revocable (living) trust as your estate planning vehicle and title all (or nearly all) of your accounts and assets in the name of your trust before you die.

The Killing of Community Property. Karen Gerstner is pleased to announce that her article, *The Killing of Community Property*, is about to be published by Texas Tech Law School's *Estate Planning and Community Property Law Journal.* In a future newsletter, we will explain some of the concepts and major points discussed in that article.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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